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Deconstructing Daschle #1

Do Tax Cuts Cause Higher Interest Rates? No!

On January 4, 2002, Senate Majority Leader Tom Daschle gave a speech characterized by his aides as a "New Growth Agenda for the American Economy." This paper is the first in a series of several critiquing Senator Daschle's remarks.

> ***Investors understand that the dwindling surplus means the federal government may have to borrow money soon or, at the very least, won't be paying down nearly as much of the debt as had been expected. That is keeping long-term interest rates higher than they would have been. And the continued high interest rates and the adverse impact on investor confidence in turn leads to less investment, less consumption, more job losses, and bigger deficits. That's the hidden tax of the current fiscal policies.***
>
> **– Senate Majority Leader Tom Daschle, January 4, 2002**

Senator Daschle's assertion that the Bush tax cuts have caused higher interest rates is patently absurd. Mortgage rates hit their 30-year low in November – five months after President Bush signed the tax cuts into law. Senator Daschle must have missed the record number of families refinancing their mortgages last fall. Far from being taxed, these families are enjoying the lowest mortgage costs in a generation.

But let's look at the bigger issue. Do tax cuts, and the higher levels of government borrowing that may result, cause interest rates to rise? The answer, quite emphatically, is NO. Even if you accept the convention that lower marginal tax rates cause lower tax revenues, there is little evidence that any but the most dramatic changes in federal borrowing have *any* impact on long-term interest rates.

This lack of connection has two implications. First, contrary to Senator Daschle's claim, the tax cuts passed last year by the Republican Congress retain their economic benefits without causing offsetting, harmful increases in interest rates. Second, Senator Daschle's alternative vision for economic growth – a vague agenda of unspecified "fiscal disciplines" referred to in his January 4 speech – is designed to reduce possible deficits and therefore reduce long-term interest rates. Yet, as no connection between the two exists, the Daschle alternative offers no economic benefits to Americans even it did manage to restore surpluses.

Scholars Say No Connection Between Interest Rates and Deficit

A recent paper authored by American Enterprise Institute resident scholar Kevin Hassett and visiting scholar Charles Calomiris frames the issue nicely:

> Given the strong statements [that deficits cause higher interest rates], one would expect to be able to point to careful economic analyses to support those statements about the reactions of interest rates to moderate increases in deficits. The surprising fact is that few such studies exist. To the contrary, every modern study that has been published on this topic, of which we are aware, has failed to find any link between moderate increases in deficits and rises in interest rates. As Professor Paul Evans (1985, 1987a, 1987b) of Ohio State University pointed out in his careful studies of links between deficits and interest rates in several countries, even the large deficits produced by wartime spending had no discernible effect on long-term interest rates. Other studies published since Evans' papers on this topic have reached similar conclusions. ["Marginal Tax Rate Cuts and the Public Tax Debate," by Charles W. Calomiris and Kevin A. Hassett, for the American Enterprise Institute, 12/14/01]

The authors provide a list of more than a dozen economic studies [see attached] dating back 20 years that all arrive at the same basic conclusion – that there is little or no connection between federal budget deficits, even the large deficits caused by World War II, and long-term interest rates. One such study, by Professor Paul Evans cited above ["Do Large Deficits Produce High Interest Rates?"], concludes:

> There are three periods during which the federal deficit has exceeded 10 percent of national income. In none of these periods did interest rates rise appreciably. Regression analysis applied to data from these three periods has not uncovered a positive association between deficits and interest rates. There also appears to be no evidence for a positive association between deficits and interest rates during the postwar period. I conclude from this survey that the concerns of the popular press and many economists may be misplaced. [*American Economic Review*, March 1985, p. 68]

Could deficits *ever* cause higher interest rates? According to Hassett and Calomiris, they would if the growth in government debt, measured relative to the economy, were to permanently outstrip overall economic growth, forcing the central bank to monetize the debt:

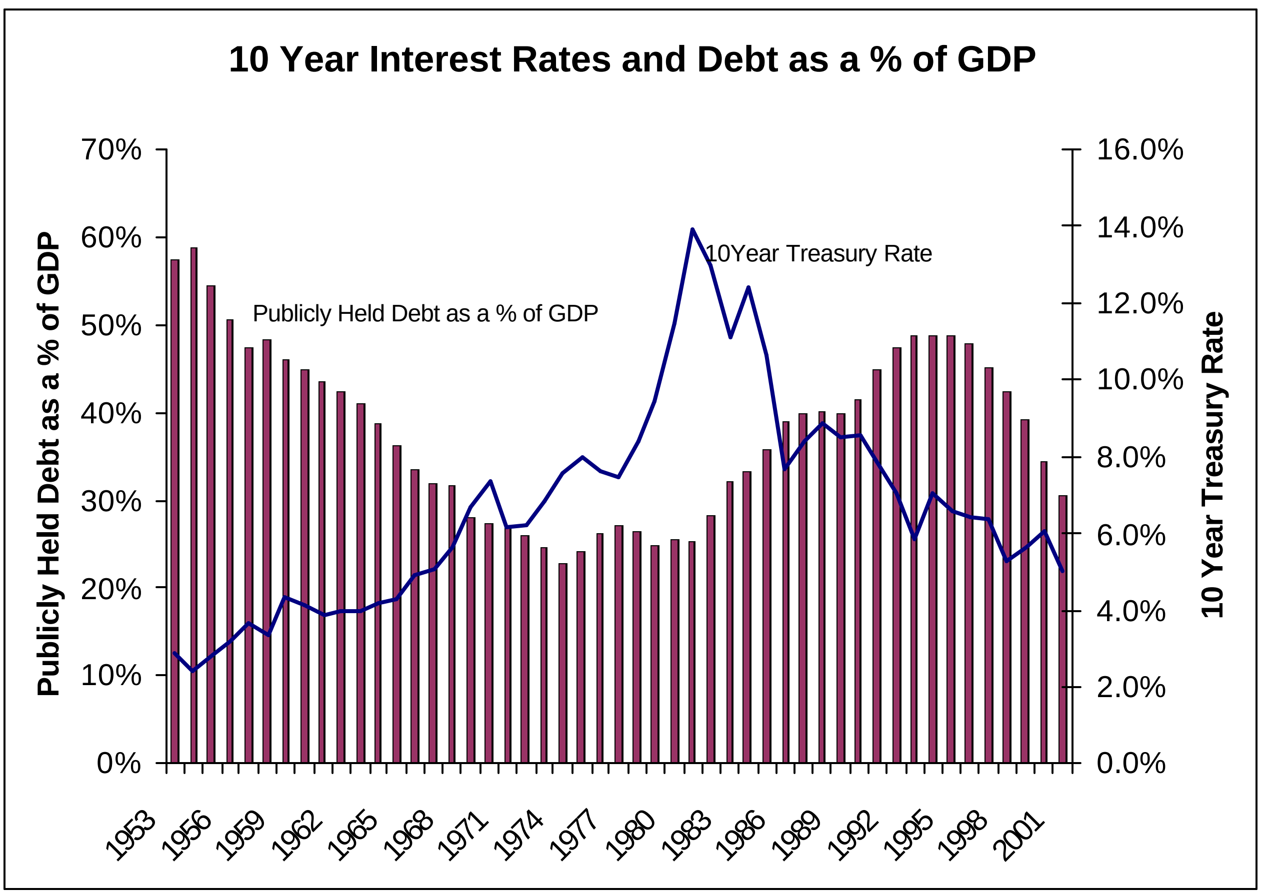
> If persistent deficits lead to permanent government debt growth in excess of the real growth rate of the economy, then there is no alternative to inflationary money creation to repay the growing debt. That money creation and inflation will be anticipated, and will thereby produce immediate increases in long-term interest rates. But so long as debt grows at a slower rate, it will be absorbed into the growing balance sheet of the central bank, and thus pose no threat to nominal interest rates. ["Marginal Tax Rate Cuts and the Public Tax Debate," 12/14/01]

Measured by the Joint Committee on Taxation, the Bush tax cuts of last summer will reduce federal revenues and increase federal debt payments by $1.7 trillion over 10 years. According to the Congressional Budget Office, the total economy during that time will add up to about $140 trillion. Thus, the tax cut amounts to slightly more than one percent of GDP, hardly a dramatic rise in government debt.

Furthermore, all this hand-wringing over debt and deficits follows on a year in which we've had the second largest surplus in U.S. history. Barring a spending binge by Congress, federal debt measured against national income will continue to decline this decade.

Economic Practice and Interest Rates

With interest and debt, we have clear case where theory and practice match up. John Barry, Chief Economist at the Tax Foundation, observes, "As oft repeated and widely accepted as the positive correlation between interest rates and publicly held federal debt is, there simply is no evidence of its validity." Barry backs up his comment with a chart matching federal debt against interest on the 10-year Treasury note going back almost 50 years.



Source: Tax Foundation

As can be seen, from 1953 through 1982, federal debt generally declined as a percentage of GDP. At the same time, interest rates rose dramatically. Then, from 1982 until 1994, federal debt rose compared to national income; meanwhile interest rates collapsed! Finally, since 1994 we have seen federal debt decline sharply, aided by four years of fiscal surpluses, while interest rates fell, rose, and then fell again.

This lack of correlation between interest and government debt is not limited to the United States. The previous cited study from Professor Evans noted this, and more recently, Alan Reynolds from the CATO Institute has observed that Japan has the world's lowest interest rates and the world's biggest budget deficit.

Election-Year Economics Versus Real Economics

In his January 4 speech, Senator Daschle blamed the tax cuts for eliminating the surplus and making the recession worse. These claims are simply wrong. The tax cut didn't consume the surplus – the slowing economy did the majority of that – and whatever budget impact it did have had no impact on interest rates, either short- or long-term.

Fiscal policy should be based on real economic factors, not convenient tag lines. For federal policies to affect the economy, they need to change people's behavior. Marginal rate cuts like those taking effect this year do just that – they encourage people to work, save, and invest. On that, the record is clear. The record is also clear that reducing marginal tax rates does not cause higher interest rates. To the contrary, for the past 20 years we've had both lower tax rates *and* lower interest rates.

For this reason, policies that reduce barriers to investment, job creation, and growth are good for the economy not only during good times, but also when the economy is dragging. As Congress renews consideration of an economic stimulus package this year, those are the policies on which it should focus.

Written by RPC Deputy Staff Director Brian Reardon, 224-2946

Editor's Note: We note that the study, "Marginal Tax Rate Cuts and the Public Tax Debate," by Charles W. Calomiris and Kevin A. Hassett, for the American Enterprise Institute, dated December 14, 2001, is marked as "preliminary and incomplete." We quote from it with the authors' permission.

Attachment: A list of economic studies compiled by AEI scholars Calomiris and Hassett (see above note), making the case that there is little or no connection between federal budget deficits and long-term interest rates.